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M. Fahim Khan

Macro Consumption Function in an Islamic Framework

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In his article "Macro Consumption Function in an Islamic Framework" Professor M. Fahim Khan has demonstrated that consumption in an Islamic economy is likely to be lower and savings larger than if the same economy were operating on a secular basis. He, therefore, finds no room for the apprehensions raised in some quarters that the process of Islamization now going on in Muslim societies may tend to reduce the investment potential, thus impeding their pace of economic progress.

Professor Khan has developed his argument in a systematic way. He has designed a cogent set of equations to drive home his point and also constructed appropriate illustrations for purposes of explanation. Yet, his work is not entirely free from weaknesses. Some of these are briefly discussed below.

To begin with, there is some confusion over the concept of consumer's rationality in secular economics and Islam.

First, it is presumed that in both cases a rational consumer is the one who is neither a miser nor a spendthrift; the distinction being that a Muslim has also to make E_2 type of expenditures in the way of Allah, (pp.2-3).

One wonders if modern economic theory with its positive stance really cares for such value loaded concepts as miserliness or extravagance. It has a straight forward view that a rational consumer is one who allocates his income among various uses in such a way that his satisfaction is maximized.⁽¹⁾ These uses may serve materialistic desires, they may include ethical purposes involving E_2 expenditures.⁽²⁾ Modern economics is neutral towards the ends, it deals with extremum solutions.

(1) The analysis of consumer's behaviour right from the utility based explanations to revealed preference and beyond rests on this view of rationality in secular economics.

(2) True, secular economies does not explicitly discuss E_2 type expenditures but the same are at a much larger scale in the Western economies than in many of the Muslim Societies if only because the affluent can afford to be more generous.

The remark that it by-passes the question of achieving rationality (p.6) is not very apt.

Second is the view of hoarding in the two cases. We are told that in modern economic theory a rational consumer "will not hoard his wealth" (p.2). On the contrary, in the list of options available to a Muslim with regard to the use of his savings, the very first entry reads: "Hoard it and pay 2.5% of it every year in the way of Allah" (p.7) as though Islam permits hoarding, and at a small price!⁽³⁾ Professor Khan has reversed the positions. One doubts if secular economics excludes hoarding from rational behaviour in case one derives satisfaction from having the ability to touch his money as and when he pleases. Indeed, the liquidity preference theory of interest grants status to this desire and allows a price to forego the same. On the other hand, there are a number of Quranic verses that severely condemn the hoarding of wealth (e.g. 70:18). *Zakah* may be, if at all, a mild spur for the people to put their savings back into the circular flow of money, it can never be interpreted as a charge for condoning hoarding.

This brings us to another point. Professor Khan is mistaken in presuming that the payment of *zakah* required at 2.5% will induce people to put the *major* part of their savings into investment (entry 6 on page 8). It is easy to see that if the rate of profit in the economy were a moderate 15% one would earn enough to meet the *zakah* obligations on all his savings by investing only their one-sixth - a meagre portion. Here, it is the anti-hoarding injunctions of Islam that may work, not its institution of *zakah*.

Next, Professor Khan regards the amount of payable *zakah* Z as the lower limit for E_2 type of expenditures. However, he seems to preclude the notion of an upper limit to E_2 which in fact can be deduced in the light of Islamic injunctions. In the short run $Y_U = \bar{Y}_U$ a constant, and

$$\bar{Y}_U = E_1 + E_2$$

E_1 and E_2 become competing uses of Y_U in the sense that one can be increased only by reducing the other. Now, the Islamic requirement for self-maintenance which Professor Khan himself emphasizes (p.5) implies a minimum value for E_1 , say E_1^* . This automatically sets a limit for E_2 at the upper end of the scale. Thus one may write

$$Z \leq E_2 \leq \bar{Y}_U - E_1^*$$

$$\text{or } \frac{Z}{\bar{Y}_U} \leq \frac{E_2}{\bar{Y}_U} \leq \frac{E_1^*}{\bar{Y}_U}$$

Finally, a word about Professor Khan's main thesis i.e. the consumption basket of a Muslim will in general be smaller,⁴ and savings larger, than that of a secular consumer under similar circumstances. May be, he is right, but the conclusion does not *necessarily* follow from his elaborate structure.

(3) The remark may have those in mind who deviate from the right path. But then the explicit assumption of the argument is that "Muslims practice Islamic Values", (p.22).

In Professor Khan's scheme mainly three factors influence the division of a Muslim's income between E_1 and E_2 uses, and of E_1 between consumption and savings. These are (i) obligatory *zakah* (ii) additional voluntary spending in the way of Allah and (iii) restraint on consumption to shun *Israf*. These are expressed as ratios of relevant variables for the purpose of analysis as Z , Z_1 , and β respectively.

Now Z and Z_1 operate on E_2 . Assuming Z as fixed, E_2 is an increasing function of Z_1 . Increase in E_2 relative to income, under the combined influence of Z and Z_1 , tends to reduce E_1 . If consumption remains unchanged savings must decline. Here enters the variable β into the picture. Both Z_1 and β are functions of T - the degree of God fearingness. Since both are positively related to T , if Z_1 increases β must increase. Professor Khan presumes that the rise in β will be large enough to reduce C_U to overcome the adverse effects on S_U of an increase in "a" which combines the effects of Z and Z_1 . However, he has used partial derivatives in constructing his tables. He might have landed himself in difficulties with his conclusions had he used the total differentiation technique that was really needed for the purpose.⁽⁴⁾

Further, although *zakah* is calculated on past accumulations it is paid only out of current income as $Y_U = E_1 + E_2$. The estimation base of *zakah* at the macro level is likely to be almost always greater than Y_U . Therefore, it will invariably absorb more than 2.5% of current income, depending on the ratios of *zakahtable* wealth to Y_U . The larger is this ratio the greater is likely to be the impairing effect of Z on savings. Unless one knows this ratio and can conclusively demonstrate that the rise in β will more than offset the effects of Z and Z_1 on savings Professor Khan's results remain of a purely tentative character. Nevertheless, his effort is commendable and suggests areas for further research.

(4) One of the reasons given is that "it includes only permissible things and excludes prohibited things" (p.7).
But can we establish the proposition in value terms?